

September 8, 2008

Bailout?

Fannie Mae/Freddie Mac

This weekend the US federal government bailed out the shareholders of Fannie Mae and Freddie Mac. Also in the news is the ouster of Kerry Killinger, CEO and former Chair of Washington Mutual. The markets are reacting favorably to both news items, although the gains have subsided a bit as the day goes on.

Where does it stop? 10 years ago it was considered a rare event when LTCM was bailed out. Then the Savings & Loan industry was rescued. The last decade has found no bubble too big, and investors were bailed out with low interest rates after the crash. 911 came first, then equities themselves, and then the housing market took advantage of low borrowing rates to lever up their balance sheet. This created excess demand and many fortunes. Those who were left standing after the music stopped did not do as well, to say the least. Now Fannie and Freddie are having their day in the case study spotlight. The reason for these Government Sponsored Entities (GSE), to provide a pass through to the residential securitization market, did not take down these behemoths. No, these semi government entities decided that they should hold huge amounts of the securitized residential mortgage backed securities in their own portfolios, and that they should borrow using the low rates guaranteed them by their perceived governmental status. I guess we now know that they truly are government entities, although the stockholders ultimately lost as regulatory oversight lost out to lobbying (FNM in December 2000 was valued at nearly \$90). With no dividends being paid and currently a penny stock, they are more like an option than a share in the value of the firm.

It remains to be seen why the FHLB system was included in this bailout. Are they anticipating one or more of them to blow up? Is it possible that they have created the next “unintended consequence” by including them?

Please help me to understand why lobbying efforts for Fannie and Freddie were still ongoing prior to this weekend.

Short term issues – credit default swaps, ABS, HELOC

Long term – food, commodities, ethanol, energy

So what are the next bubbles to form and burst? This does not mean that the current financial crisis is over by any means. The credit default swap market has yet to digest FNM and FRE, and the contagion to home equity loans and residential/commercial mortgages during an economic slowdown could cause a lot more damage to the consumer’s psyche. Credit cards are hanging on so far, but can’t be far from the edge.

Longer term, the interaction between ethanol/biofuels and food prices is causing issues worldwide. I expect to see a bubble build in alternative energy sources such as wind power. Get in now, and be ready to get out when the next new thing appears.



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